

TREASURY - GENERAL

STATE INVESTMENT COUNCIL

**State Investment Council's Policy Concerning
Political Contributions and Prohibitions on
Investment Management Business**

Proposed New Rule: N.J.A.C. 17:16-4

Authorized By: State Investment Council,
Peter A. Langerman, Director, Division of Investment

Authority: N.J.S.A. 52:18A-91

Calendar Reference: See Summary below for explanation of exception to calendar requirement.

Proposal Number: PRN 2004-

Submit comments by December 17, 2004 to:

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The agency proposal follows:

Summary

The summary that follows is taken directly from the "Policy Statement of the State Investment Council – Background Memorandum," presented at the August 18, 2004 State Investment Council Meeting. By unanimous vote of the Council, the policy resolution was adopted and became effective immediately.

"The policy resolution below is essentially a tougher adaptation of G-37, the Municipal Standards Rulemaking Board regulation governing political contributions in the public securities arena. We are indebted to former SEC Chairman Arthur Levitt, who shared with us his perspective and material from his effort in 1999 to impose disclosure obligations and contribution limitations on asset management firms.

The Council's policy resolution incorporates four central principles. First, it prohibits the Division from engaging or retaining any investment adviser where the adviser (or its investment professionals, executive officers, solicitors or political committees) has made a political contribution to any incumbent or candidate for State office (Governor, State Legislators, and associated committees) over the prior two years. Second, it prohibits investment advisers from doing indirectly - through consultants, lobbyists, bundling the contributions of others, third-party intermediaries, county committees, "independent committees," charitable contributions, etc. - what they cannot do directly. Third, more specifically, it precludes any compensation arrangement with third-party intermediaries where the intermediary (or its partners, political committee, etc.) has made contributions covered under the Council's policy, and where the intermediary's compensation is tied to generating investment management business from the State. Finally, the resolution requires asset managers soliciting or doing business with the Investment Division to disclose quarterly to the Council relevant contributions to New Jersey political entities.

These principles reflect several underlying judgments.

First, Council action is appropriate under the law and critical as a matter of policy. In general, prohibitions on political contributions can raise issues involving the right to free speech. However, a regulatory regime which does not limit political contributions per se, but imposes restrictions only on those who wish to do business with the Division, should withstand scrutiny.

On a policy level, the Council has no standing to address the generic issue of campaign finance law and private contractors. But the Council has policy-making authority regarding investment activity, and there is a special fiduciary duty to protect the integrity of the pension fund system. In effect, we are dealing with a regulated industry imbued with a unique public interest and which warrants aggressive policy oversight.

Second, we should recognize that outside Vermont and Connecticut, no state has gone beyond a pure disclosure approach (i.e., no prohibitions on contributions). Arguably, transparency (name and shame) is a sufficient check against abuse, and it is unfair to impose regulatory burdens on one set of economic actors which create compliance costs and may place the affected firms at a competitive disadvantage in the political marketplace. Since many investment management providers are subsidiaries of

large financial services conglomerates, we should be sensitive to establishing an inhospitable environment and an unlevel playing field for companies contributing substantially to the State labor market.

On balance, however, the practices of other states are largely distinguished by the magnitude of their loopholes. In Vermont and Connecticut, direct campaign contributions to the state treasurer are prohibited, but all the remaining windows and doors through which political dollars flow remain open. Pennsylvania, Rhode Island, Maryland, and Oregon require disclosure, but there are no limitations on contributions. Most states do not even require special disclosure by investment managers. In this arena, common practice is not best practice, and best practice exists only in theory.

Probably the most difficult issues surround the multifarious indirect paths through which economic actors purchase political good will. Among high-end sophisticates in the political marketplace, it may take the form of funneling contributions to a low-visibility political committee which then makes independent expenditures or transfers the funds to another committee, known as ‘wheeling.’ Much more commonly, it involves retaining well-connected intermediaries whose influence arises at least in part from political contributions. We should not want to discourage investment management companies – or their large corporate parents – from doing business with New Jersey law firms, consultants or lobbyists. We do not want to incentivize prospective clients of lawyers or consultants to discriminate in favor of out-of-state firms less likely to be politically involved in New Jersey. We do not want a regulatory regime which ignores the reality that, one way or another, companies must incur marketing expenses. On the other hand, we do not want investment managers to do indirectly (hiring major contributors as intermediaries) what it disallows them from doing directly (treating their own political contributions as a business development tool). Our policy resolution seeks to strike that balance.”

As is stated in the third paragraph of this Summary, which is quoted directly from the State Investment Council’s background memorandum, the proposed new rules are intended to: 1) prohibit the Division from engaging or retaining any investment adviser where the adviser (or its investment professionals, executive officers, solicitors or political committees) has made a political contribution to any incumbent or candidate for State office (Governor, State Legislators, and associated committees) over

the prior two years; 2) prohibit investment advisers from doing indirectly - through consultants, lobbyists, bundling the contributions of others, third-party intermediaries, county committees, “independent committees,” charitable contributions, etc. – what they cannot do directly; 3) more specifically, preclude any compensation arrangement with third-party intermediaries where the intermediary (or its partners, political committee, etc.) has made contributions covered under the Council’s policy, and where the intermediary’s compensation is tied to generating investment management business from the State; and 4) require asset managers soliciting or doing business with the Division of Investment to disclose quarterly to the Council relevant contributions to New Jersey political entities.

Because the Division is providing a 60-day comment period on this notice of proposal, this notice is exempt from the rulemaking calendar requirement pursuant to N.J.A.C. 17:30-3.3(a)5.

Social Impact

The proposed new rules establish the strictest campaign financing restrictions of any state in the country governing the selection of investment management firms to provide investment management services to the State pension funds. Therefore, any social impact that may arise from the proposed new rules is anticipated by the Council and the Division to be positive, because the use of outside managers to invest a portion of the pension portfolio would be free from undue influence from campaign contributions.

Economic Impact

No adverse economic impact is anticipated from adoption of these proposed new rules. Any impact on the public would be positive because outside managers would be chosen on the firm’s merits. Investment management firms engaged to provide investment management services to the State shall incur administrative costs in complying with the quarterly reporting requirement of N.J.A.C. 17:16-4(b). The State Investment Council and the Division of Investment do not anticipate that such costs will be significant.

Federal Standards Statement

A Federal standards analysis is not required because the investment policy rules of the Division of Investment are under the auspices of the State Investment Council, and are not subject to any Federal requirements or standards.

Jobs Impact

The State Investment Council and the Division of Investment do not anticipate the loss of any jobs by virtue of these proposed new rules. There will likely be a need for additional personnel at the Division of Investment to monitor alternative investments.

Agriculture Industry Impact

The proposed new rules shall have no impact on the agriculture industry.

Regulatory Flexibility Statement

Some of the firms seeking to do investment management business with the State may qualify as small businesses, as the term is defined in the Regulatory Flexibility Act, N.J.S.A. 52:14B-16 et seq., and would be subject to the rules' prohibitions and reporting requirements. It is not anticipated that the costs of compliance with these requirements will be substantial. Small businesses should not have to engage professional services in order to comply. The State Investment Council and the Division of Investment believe that uniform application of the rules is necessary to protect the fiscal integrity of the pension fund system and do not anticipate that the requirements will have a significantly adverse impact on small businesses.

Smart Growth Impact

The proposed new rules are not anticipated to have an impact on the achievement of smart growth and implementation of the State Development and Redevelopment Plan.

Full text of the proposal follows.